

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 21st Floor
San Francisco, California 94105**

NOTICE OF PROPOSED ACTION

DATE: August 7, 2002

REGULATION FILE: RH02019392

SUBJECT OF PROPOSED RULEMAKING

The Insurance Commissioner proposes to adopt the regulations described below after considering comments from the public. The Commissioner proposes to add to Title 10, Chapter 5, Subchapter 3 of the California Code of Regulations the new Article 12.3, consisting of new Sections 2542, 2542.1, 2542.2, 2542.3, 2542.4, 2542.5, 2542.6, 2542.7 and 2542.8. The regulations will codify rules that are already in force regarding valuation of life insurance policies for purposes of determining minimum aggregate reserves.

PUBLIC HEARING

No public hearing has been scheduled in connection with this proposed action. A public hearing will be held, however, if no later than fifteen (15) days before the last day of the public comment period one of the contact persons identified below receives from an interested person or his or her duly authorized representative a written request for a public hearing. The sole purpose of such a hearing would be to address the merits of the proposed regulations.

AUTHORITY AND REFERENCE

The proposed regulations will implement, interpret and make specific the provisions of Insurance Code section 10489.94, with reference also to Insurance Code sections 790.03, 10489.15, 10489.2, 10489.4, 10489.5, 10489.7 and 10489.9. Insurance Code section 10489.94 provides the authority for this rulemaking.

PRESENTATION OF WRITTEN COMMENTS; CONTACT PERSONS

All persons are invited to submit written comments on the proposed regulations during the public comment period. The public comment period will end at 5:00 p.m. on September 24, 2002. Please direct all written comments to the following contact person:

George Teekell, Staff Counsel
California Department of Insurance
45 Fremont Street, 21st Floor
San Francisco, CA 94105
Telephone: (415) 538-4390

Questions regarding procedure, comments, or the substance of the proposed action should be addressed to the above contact person. If he is unavailable, inquiries may be addressed to the following backup contact person:

Ahmad Kamil, Senior Life Actuary
California Department of Insurance
300 South Spring Street, South Tower
Los Angeles, CA 90013
Telephone: (213) 346-6147

DEADLINE FOR WRITTEN COMMENTS

All written materials must be received by the Insurance Commissioner, addressed to one of the contact persons at his respective address listed above, no later than 5:00 p.m. on September 24, 2002. Any written materials received after that time will not be considered.

COMMENTS TRANSMITTED BY E-MAIL OR FACSIMILE

The Commissioner will accept written comments transmitted by e-mail provided they are sent to the following e-mail address: teekellg@insurance.ca.gov. The Commissioner will also accept written comments transmitted by facsimile provided they are directed to the attention of George Teekell and sent to the following facsimile number: (415) 904-5490. **Comments sent to other e-mail addresses or other facsimile numbers will not be accepted. Comments sent by e-mail or facsimile are subject to the deadline set forth above for written comments.**

ADVOCACY OR WITNESS FEES

Persons or groups representing the interests of consumers may be entitled to reasonable advocacy fees, witness fees, and other reasonable expenses, in accordance with the provisions of California Code of Regulations, Title 10, Chapter 5, Subchapter 4.5, in connection with their participation in this matter. Interested persons should contact the Office of the Public Advisor at the following address in order to inquire about the appropriate procedures:

California Department of Insurance
Office of the Public Advisor
300 Capitol Mall, 17th Floor
Sacramento, CA 95814
(916) 492-3559

A copy of any written materials submitted to the Public Advisor regarding this rulemaking must also be submitted to the contact person listed above. Please contact the Office of the Public Advisor for further information.

INFORMATIVE DIGEST

SUMMARY OF EXISTING LAW AND POLICY STATEMENT OVERVIEW

Existing law requires the Commissioner to determine that a life insurer's reserves are adequate to cover its projected claims and other obligations. This process necessarily involves a determination that the funds will be available in the future when claims are made. As a result, it is necessary, among other things, to have an actuarially based understanding of the expected mortality of the population of insureds. As the health and life expectancy of the population changes, it is necessary to update the tables which reflect the most current, accurate mortality information. Found at Insurance Code, Division 2, Part 2, Chapter 5, Article 3A, the Standard Valuation Law specifies minimum standards for maintaining reserves. The proposed regulations will implement Section 10489.94 of the Insurance Code, which was added to the Standard Valuation Law in Statutes of 1999, Chapter 868, Section 3 (Senate Bill 374, Lewis).

Insurance Code section 10489.94, which the proposed regulations implement, was intended to clarify the law in order to rectify problems with insurers reserving inadequately for certain life insurance products. Previously, some insurers had found a loophole in existing law with regard to reserving requirements for policies with nonlevel premiums and for universal life policies with no-lapse guarantees. Substantially lower reserves were being established for these types of policies, which may contain guarantees with respect to death benefits and premiums for 10, 20 or some other number of years, than those required by the Standard Valuation Law for traditional term policies offering the same guarantees. In other words, certain "term-like" policies were not subject to the same reserving requirements as exist for similar term policies, placing the holders of these "term-like" policies at risk. As this type of premium design and reserve pattern was not contemplated by the Standard Valuation Law, the Legislature enacted Insurance Code section 10489.94 in order to clarify the intent of the law.

Insurance Code section 10489.94 authorizes the Commissioner to issue a bulletin setting forth (1) rules concerning valuation of plans with secondary guarantees and plans with nonlevel premiums or benefits and (2) tables of select mortality factors and rules for their use. The statute provides that this bulletin is to have the same force and effect, and is to be enforceable to the same degree, as formally promulgated regulations. The statute further provides that it is the Legislature's intent that the bulletin, and the regulations which are required to supersede it, contain the provisions of the National Association of Insurance Commissioners (NAIC) Valuation of Life Insurance Model Regulation Number 830 as adopted in March of 1999. Accordingly, on July 1, 2000 the Commissioner issued Department of Insurance Bulletin Number 2000-2, which for the most part is substantially identical to the indicated model regulation. The predominant policy goal of the model regulation, the bulletin and the proposed regulation is the same: Reserves need to be established that are commensurate with the guarantees made in a policy; plans which in effect mask those guarantees or seek to take advantage of a perceived loophole should be subject to the same reserving requirements as more conventional plans with comparable guarantees.

EFFECT OF PROPOSED ACTION

The proposed regulations, in turn, are in large part substantially identical to Bulletin 2000-2 which, again, is to a great extent substantially identical to Valuation of Life Insurance Model Regulation Number 830, as adopted by the National Association of Insurance Commissioners as of March of 1999. However, certain potential ambiguities in the language of the model regulation which were allowed to remain in Bulletin 2000-2, and the occasional language clarity problem introduced in the bulletin, have been eliminated in the proposed regulation text. Other differences from Bulletin 2000-2 include a statement in the current regulations of the Department's longstanding limitation, not explicitly reiterated in Bulletin 2000-2, on the use of sex-blended, "unisex" mortality tables to valuation of only those life insurance policies that are issued pursuant to certain employment arrangements. Nonetheless, because the rules embodied in the proposed regulations are otherwise largely the same as those announced in the bulletin, the proposed action will have little or no substantial effect on what has been the status quo since July of 2000, when the bulletin was issued. Even so, for purposes of this document, the effect of the proposed regulations will be discussed in terms of the impact their provisions would have had at the time Bulletin 2000-2 was issued.

Existing law requires that for each policy they issue insurers establish adequate reserves. Generally speaking, reserves must be equal to the excess, if any, of the present value of benefits payable under a policy over the present value of any future premiums. Actuarial reserves are required to be recognized on statutory valuations filed by insurers as a liability representing amounts an insurer is obligated to pay. Prior to the effectiveness of the rules embodied in the proposed regulations, lower reserves were considered by some insurers to be permissible for policies with a premium structure characterized by sharply elevated guaranteed premiums at a very late stage in the life of the policy than were required for otherwise identical policies with a flatter pattern of guaranteed premiums. Some insurers had designed policies to take advantage of a perceived loophole in the law by incorporating sharply elevated premiums at very late stages of the policy. These designs were intended simply to reduce the reserves required, as there was no serious expectation that policyholders would actually pay those higher premiums. One example of these policy designs is where an initial level premium rate is guaranteed for 30 years followed by guaranteed premiums in years 31 and later that are more than 50 times the initial guaranteed premium. The proposed regulations attempt to eliminate this loophole by requiring that reserves be calculated for each level-premium segment individually, as well as for aggregate reserves over the entire policy duration.

The proposed regulations require that reserves be calculated on a segmented basis. In the example above, reserves for the first 30 years of the policy (the first segment) would be required to be calculated separately from the reserves for years 31 and later. Under the former, strictly unitary method the reserves required to be established during the first 30 years of a policy with this design could be substantially lower than those required for a traditional 30-year term policy with identical gross premium and benefit guarantees. The reserves required to be established during the first 30 years of the example policy were

disproportionately low, because the calculation of required reserves was skewed by the impact of the very high guaranteed premiums in the thirty-first and subsequent years. This result was incongruous, because two policies that, in terms of the benefits they guaranteed, were identical for the first 30 years would be subject to very different reserving requirements during that time, even though the benefits to be reserved against were the same. The proposed regulations have the effect of eliminating this incongruity, by unambiguously requiring that, in this example, reserves for the first 30 years be considered separately from the reserves for subsequent years, thus ensuring that similar policies are subject to similar reserving requirements, during the period of such similarity.

Another effect of the proposed regulations is that for certain policies with “shadow accounts,” reserves must be adjusted to compensate for the fact that a lower level of premiums than the guaranteed gross premiums could actually be paid in order to keep the policies in effect. Specifically, this provision addresses universal life policies where actual premiums paid up to the valuation date are considered for purposes of calculating the accumulation of premiums in shadow accounts that is necessary to keep the policy in force. A shadow account works as follows: The basic policy account value is equal to premiums paid plus interest credited less mortality and expense charges. The cash surrender value is equal to the account value less a surrender charge. Ordinarily, if the account or cash value falls to zero, then the policy will expire. This is not necessarily the case, however, with a policy that has a shadow account. A shadow account is an alternate fund attached to the same policy. In the calculation of the balance in the shadow account the guaranteed interest credits are typically higher and the mortality and expense charges are typically lower than those used to determine the basic account value. The policy guarantees that the policy will not expire as long as the shadow account value is positive, even if the basic policy account value is zero or negative.

When a policy is designed in such a way that the calculation of the shadow account balance takes into account premiums that have been paid to date, the result is that in the future a lesser amount of premiums than the premiums specified in the policy will actually need to be paid in order to keep the policy in force. The proposed regulations require that for these policies the reserve calculations reflect the actual premiums paid to date, because these premiums reduce the premiums that must be paid in the future. By mandating that the calculation of reserves take into account the reduced level of premiums that actually need to be paid in order to maintain such policies in force, the rules embodied in the proposed regulations have the effect of causing premiums and/or deficiency reserves for these policies to be adjusted upward to satisfy statutory reserving requirements. The effect of the proposed regulations is to disallow the assumption that more future premiums will be received than are actually required in order to satisfy the secondary guarantee requirement.

Another effect of the proposed regulations is that they give actuaries broader discretion to adjust mortality factors based on insurers’ emerging experience with their own population of insureds and the various classes within those populations. This discretion is introduced in the form of variables known as “X factors.” Since some business, due to

underwriting, is expected to have much better mortality experience than is assumed in the statutory mortality table, the proposed regulations allow for actuarial judgment in adjusting the mortality rates for the purpose of calculating deficiency reserves. This judgment is exercised by means of X factors, which actuaries can use to adjust mortality valuation rates to reflect expected experience.

Basic reserves are equal to the excess of the present value of future benefits, based on a statutory mortality table, over the present value of future net premiums. Net premiums are a constant percentage of gross premiums that is calculated according to statutory formulae. Gross premiums are the premiums actually specified in a policy which are sufficient to keep the policy in force. If net premiums are higher than gross premiums, then deficiency reserves are required. The introduction of X factors in the proposed regulations affects the method by which these deficiency reserves may be calculated. The proposed regulations retain as the minimum mortality standard for valuation of life policies the 1980 CSO Mortality Tables, as defined in the proposed regulations. As in the past, insurers have the choice of using the mortality factors as presented in these tables or as modified using what are known as select factors.

Select factors are used to recognize the impact of underwriting. For example, a 45 year old who buys a policy and satisfies the underwriting criteria is expected to have, on average, a lower mortality than a 45 year old who purchased a policy 10 years ago. Some of the 45 year olds who purchased policies 10 years ago may have had a deterioration in health, but all the 45 year olds who just purchased policies have satisfied the underwriting requirements, such as those for good health. Select factors are applied formulaically to the values in the 1980 CSO Tables to reflect these differences in expected mortality that correspond to the amount of time that has elapsed since a policy was purchased.

The proposed regulations have the effect of increasing the range of available choices of select factors to be used in the calculation of deficiency reserves. Formerly, if an insurer elected to use select factors, the only available choice was the Ten-year Select Factors, as defined in the proposed regulations. Under the proposed regulations, if select factors are elected, insurers have the additional choice of using the new select factors incorporated into the proposed regulation. Further, if the new select factors are used, the proposed regulations allow insurers the option of using them as is or as modified by X factors. Use of X factors essentially means that an insurer can modify the factors presented in the new tables of select factors by using X percent of each such factor rather than the factor itself. The permissible values of X for purposes of these calculations are determined in compliance with six X factor tests set out in the proposed regulations. The X-factors will reflect the anticipated mortality experience of the insurer, taking into consideration its emerging experience, and will be annually certified by the appointed actuary. The insurer will comply with the six X-factor tests in the proposed regulation, and the appointed actuary will annually opine as to the insurer's compliance, for each class independently and for all classes in the aggregate.

The use of X factors for deficiency reserves effectively means use of different mortality standards for different companies and different classes within a company. It grants the appointed actuary broader discretion than do more purely formulaic reserve calculation methods.

DOCUMENTS INCORPORATED BY REFERENCE

The following documents have been incorporated by reference into the proposed regulations:

- The Commissioners' 1980 Standard Ordinary Mortality Table (1981 *Transactions of the Society of Actuaries*, Volume 33, pp. 618, 673) incorporated into the 1980 amendments to the NAIC Standard Valuation Law;
- The 1980 CSO Female Smoker and Non-smoker Mortality Rates, and the 1980 CSO Male Smoker and Non-smoker Mortality Rates, tables adopted by the NAIC in December 1983 (1984 *Proceedings of the National Association of Insurance Commissioners*, I, pp. 406-407, 410-411);
- The Blended 1980 CSO Tables B through F, adopted by the NAIC in December 1983 (1984 *Proceedings of the National Association of Insurance Commissioners*, I, pp. 396-400); and
- The select factors (1981 *Transactions of the Society of Actuaries*, Volume 33, p. 669) adopted with the 1980 amendments to the NAIC Standard Valuation Law.

MANDATES ON LOCAL AGENCIES OR SCHOOL DISTRICTS

The proposed regulations do not impose any mandate on local agencies or school districts. There are no costs to local agencies or school districts for which Part 7 (commencing with Section 17500) of Division 4 of the Government Code would require reimbursement.

COST OR SAVINGS TO STATE/LOCAL AGENCY OR SCHOOL DISTRICT OR IN FEDERAL FUNDING

The Commissioner has determined that the proposed regulations will result in no cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of the Government Code, no other nondiscretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State.

ECONOMIC IMPACT ON BUSINESSES AND THE ABILITY OF CALIFORNIA BUSINESSES TO COMPETE

The Commissioner has made an initial determination that the proposed regulations may have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states. The types of businesses that may be affected are insurers and, indirectly, independent agents and brokers. The Commissioner has not considered proposed alternatives that would lessen any adverse economic impact on business and invites interested parties to submit proposals. Submissions may include the following considerations:

- (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to businesses.
- (ii) Consolidation or simplification of compliance and reporting requirements for businesses.
- (iii) The use of performance standards rather than prescriptive standards.
- (iv) Exemption or partial exemption from the regulatory requirements for businesses.

POTENTIAL COST IMPACT ON PRIVATE PERSONS OR ENTITIES/BUSINESSES

The Commissioner is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

FINDING OF NECESSITY

The Commissioner finds that it is necessary for the welfare of the people of the state that the regulations apply to businesses.

EFFECT ON JOBS AND BUSINESSES IN CALIFORNIA

The Commissioner is required to assess any impact the regulations may have on the creation or elimination of jobs in the State of California, the creation of new businesses, the elimination of new businesses, and the expansion of businesses currently operating in the state. The Commissioner does not foresee that the proposed regulations will have an impact on any of the above but invites interested parties to comment on this issue.

IMPACT ON HOUSING COSTS

The matters proposed herein will have no significant effect on housing costs.

ALTERNATIVES

The Commissioner must determine that no reasonable alternative considered by the Commissioner or that has otherwise been identified and brought to the attention of the Commissioner would be more effective in carrying out the purposes for which the regulations are imposed or would be as effective and less burdensome to affected private persons than the

proposed regulations. The Commissioner invites public comment on alternatives to the regulations.

IMPACT ON SMALL BUSINESS

The Commissioner has determined that the proposed amendments may indirectly affect small businesses to the extent independent agents and brokers (as opposed to those who are insurance company employees) qualify as small businesses. It is conceivable that if, as a result of the changes the proposed action makes in the way insurers are required to value the applicable life insurance products, insurers offer these policies at higher premiums, then independent agents and brokers may be able to sell fewer of these policies, to the extent consumers find the product less attractive on account of higher premiums.

COMPARABLE FEDERAL LAW

There are no existing federal regulations or statutes comparable to the proposed regulations.

TEXT OF REGULATIONS AND INITIAL STATEMENT OF REASONS

The Department has prepared an initial statement of reasons that sets forth the reasons for the proposed regulations. Upon request, the initial statement of reasons will be made available for inspection and copying. Requests for the initial statement of reasons or questions regarding this proceeding should be directed to the contact person listed above. Upon request, the final statement of reasons will be made available for inspection and copying once it has been prepared. Requests for the final statement of reasons should be directed to the contact person listed above.

The file for this proceeding, which includes a copy of the proposed regulations, the statement of reasons, the information upon which the proposed action is based, and any supplemental information, including any reports, documentation and other materials related to the proposed action that is contained in the rulemaking file, is available for inspection and copying at 45 Fremont Street, 21st Floor, San Francisco, California 94105, between the hours of 9:00 a.m. and 4:30 p.m., Monday through Friday.

AUTOMATIC MAILING

A copy of this notice, including the informative digest, which contains the general substance of the proposed regulations, will automatically be sent to all persons on the Insurance Commissioner's mailing list.

WEBSITE POSTINGS

Documents concerning this proceeding are available on the Department's website. To access them, go to <http://www.insurance.ca.gov>. Find near the top of the page the major heading 'Protecting Consumers.' In this section, scroll down until you see the subheading 'BE INFORMED.' Click on the nearby 'Proposed Regulations — Search' link. When the 'Search or

Browse for Documents for Proposed Regulations' screen appears, you may choose to find the documents either by conducting a search or by browsing for them by name.

To search, enter "RH02019392" (the Department's regulation file number for these regulations) in the search field. Alternatively, search using as your search term the California Insurance Code section number of a code section that the regulations implement (for instance, "10489.94"), or search by keyword ("valuation," for example, or "mortality"). Then, click on the 'Submit' button to display links to the various filing documents.

To browse, click on the 'Browse All Regulations' button near the bottom of the screen. A list of the names of regulations for which documents are posted will appear. Find in the list the 'Valuation of Life Policies, including Select Mortality Tables' link, and click it. Links to the documents associated with these regulations will then be displayed.

MODIFIED LANGUAGE

If the regulations adopted by the Department differ from those which have originally been made available but are sufficiently related to the action proposed, they will be available to the public for at least 15 days prior to the date of adoption. Interested persons should request a copy of these regulations prior to adoption from the contact person listed above.

Dated: August 7, 2002

HARRY W. LOW
Insurance Commissioner

By _____/s/
Richard G. Krenz
Assistant Chief Counsel